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UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF CALIFORNIA

In re  
CONNECTIX CORPORATION,  
Debtor.

Case No.: C-07-03192 RMW

CHAPTER 7

USBC Case No. 05-55648-MM7

**APPELLEE'S OPENING BRIEF**

**Appeal Filed: May 17, 2007**

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## I. INTRODUCTION

This is an appeal from the Bankruptcy Court's determination regarding the allowance of a claim. Appellant EOP, the Debtor's landlord, presented a claim in the bankruptcy case for \$2,335,253.99. The claim consisted of an undisputed \$161,558.52 on account of unpaid rent as of the date the Debtor surrendered the premises, and a disputed \$2,173,695.47 on account of post-surrender rent. Besides disputing the proper calculation of the post-surrender rent claim under bankruptcy law, the Trustee's Objection to EOP's claim argued that the landlord's claim should be reduced by the amount it collected under a Letter of Credit ("LOC") posted by the Debtor as security.

In a carefully reasoned published decision,<sup>1</sup> the Bankruptcy Court sustained the Trustee's position on both counts.

First, it concluded that the claim for post-surrender rent should be calculated based on the remaining time left on the lease, not based on the total rent which would have been payable. That decision was correct under the language of the Code and the weight of applicable decisional authority, and it has been validated by the Ninth Circuit in a case decided after the opinion in this case.<sup>2</sup>

Next, the Bankruptcy Court followed Ninth Circuit authority to determine that the LOC proceeds reduced the allowed claim. EOP's contention that *Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co.*, \_\_\_ U.S. \_\_\_, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007) mandates reversal is wrong. *Travelers* does not address the issues presented by this appeal. Moreover, in *Travelers*, the Supreme Court followed the same path of analysis adopted by the Bankruptcy Court here – looking first to the provisions of the Bankruptcy Code and then to the pre-Code case authority governing claim allowance. EOP overstates and misrepresents the holding in *Travelers* when it argues that the Supreme Court abandoned existing jurisprudence and adopted a "black letter" rule requiring "textual support" in the "plain language of the Code."

<sup>1</sup> *In re Connectix*, 372 B.R. 488 (Bankr.N.D.Cal. 2007). Appellees' incorporate the Bankruptcy Court's statement of facts.

<sup>2</sup> *In re El Toro Materials Co., Inc.*, \_\_\_ F.3d \_\_\_, 2007 WL 2822019, \*2 (9<sup>th</sup> Cir. October 1, 2007) (cap is measured as a fraction of the remaining term).

Finally, EOP raises an objection to the procedure used by the Bankruptcy Court for evidentiary matters despite the fact that it never objected to that procedure below. This newly raised objection is denominated “Issue 3” in EOP’s statement of issues on appeal. It should be rejected for two reasons. First, the Bankruptcy Court’s decision is proper based on the terms of the lease between EOP and the Debtor, which EOP itself submitted to the Bankruptcy Court. Second, EOP waived its objection by failing to raise it below, which would have allowed the Court and the parties a fair opportunity to address it then. Even if the objection had not been waived, there was no reversible error because the Bankruptcy Court decision was rendered in conformity with the applicable rules of procedure.

## II. APPELLEE’S STATEMENT OF THE CASE

Notwithstanding EOP’s efforts to prejudice this Court with inaccurate, irrelevant, unsubstantiated, and slanderous accusations against the Debtor and its officers, directors, and shareholders,<sup>3</sup> this appeal presents only two issues:

1. Did the Bankruptcy Court correctly conclude that the claim for post-abandonment rent is calculated based on 15% of the time remaining on the lease instead of 15% of the total rent that would have been paid?

2. Did the Bankruptcy Court correctly conclude that the allowed amount of the claim should be net of the security deposit (letter of credit), which the landlord collected?

All parties agree that the first issue presents a pure question of statutory construction. EOP seeks to obtain reversal on the second issue by arguing both that the Bankruptcy Court was wrong as a matter of law in its interpretation of the Bankruptcy Code, and that its decision was not supported by proper admissible evidence. The Court’s decision, however, is properly based on the lease agreement, is consistent with Ninth Circuit authority, and was rendered in

<sup>3</sup> See e.g., Appellant’s Opening Brief at 6. The Appellant’s Statement of the Case understandably includes only EOP’s side of the story. Appellees dispute EOP’s accusations and they affirmatively contend that they properly fulfilled all of their legal obligations under applicable California law. See e.g., *In re Fox West Coast Theaters*, 88 F.2d 212 (9<sup>th</sup> Cir. 1937) (it is legal for shareholder and director to file bankruptcy and reduce landlord’s claims and to declare \$8,000,000 dividend shortly prior to the bankruptcy filing) Appellees include a portion of the other side in their designation of record which appears in the Appellant’s Excerpts of Record at Tabs 19-31.

conformity with the procedure dictated by the Bankruptcy Court's Local Rules. EOP never disputed the predicate facts for the Court's ruling, nor did it request an evidentiary hearing as permitted by the Local Rules. Accordingly, it may not now be heard to argue that the decision is reversible for lack of supporting evidence.

### III. ARGUMENT

#### A. **The Bankruptcy Court correctly ruled that EOP's claim for post-surrender rent must be calculated based on 15% of the time remaining on the lease.**

11 U.S.C. § 502(b)(6) provides that claims for unpaid rent are to be allowed only to the extent that they do not exceed:

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of--

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

The Ninth Circuit very recently addressed this section of the Bankruptcy Code, explaining that the cap is measured as a fraction of the remaining time on the lease:

Claims made by landlords against their bankrupt tenants for lost rent have always been treated differently than other unsecured claims. Prior to 1934, landlords could not recover at all for the loss of rental income they suffered when a bankrupt tenant rejected a long-term lease agreement; future lease payments were considered contingent and thus not provable debts in bankruptcy.... The solution was a compromise in the Bankruptcy Act of 1934 allowing a claim against the bankruptcy estate for back rent to the date of abandonment, plus damages no greater than one year of future rent.

Congress dramatically overhauled bankruptcy law when it passed the Bankruptcy Reform Act of 1978. However, section 502(b)(6) of the 1978 Act was intended to carry forward existing law allowing limited damages for lost rental income.... Only the method of calculating the cap was changed. Under the current Act, the cap limits damages "resulting from the termination of a lease of real property" to "the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease." 11 U.S.C. § 502(b)(6)... *The structure of the cap-measured as a fraction of the remaining term*-suggests that damages other than those based on a loss of future rental income [e.g., damages

1 resulting from waste] are not subject to the cap...(Emphasis  
2 Added.)(Citations Omitted)<sup>4</sup>

3 Notwithstanding this recent Ninth Circuit explanation of the Code, EOP asks this Court to  
4 reverse the Bankruptcy Court and order calculation of the “cap” based on 15% of the money  
5 remaining due under the lease rather than the next ensuing 12.3 month period.<sup>5</sup>

6 EOP incorrectly represented to the Bankruptcy Court, and it incorrectly represents to this  
7 Court, that “15% of money” is the “majority rule.” As the Bankruptcy Court recognized, the  
8 “money” model is not in fact the majority rule at all, and the cases appear evenly divided. More  
9 importantly, recently decided cases and those that provided a reasoned analysis of the issue  
10 unanimously follow the “time” rule. An examination of the early cases, which adopted the  
11 “money” model, reveals that most did so without analyzing the language of § 502(b)(6) or the  
12 history of the provision. The Bankruptcy Court correctly determined that a “15% of money”  
13 calculation has no support in either the language of the Bankruptcy Code or in the historical  
14 basis of the statutory provision, and that the cap should be based on the rent which would be  
15 owed for the 12.3 months following abandonment of the premises.<sup>6</sup>

16 Section 502(b)(6) is based on pre-Code case authority and an analogous pre-Code  
17 statute, all of which were based on the time model. There is no suggestion in the legislative  
18 history that Congress intended to abandon the well known legal standard that governed  
19 calculation of the cap when it enacted § 502(b)(6).<sup>7</sup>

20 Debtor's position finds further support in the predecessor of  
21 Section 502(b)(6), Section 63(a)(9) of the Bankruptcy Act, 11  
U.S.C. § 103(a)(9) (repealed 1978). Under Section 63(a)(9) of

22 <sup>4</sup> *In re El Toro Materials Co., Inc.*, \_\_\_ F.3d \_\_\_, 2007 WL 2822019, \*2 (9<sup>th</sup> Cir. October 1,  
2007). See also, footnote 3: “...The cap maxes out at 15% of 20 years ....” EOP urges this  
23 Court to ignore *In re El Toro* by incorrectly representing that these statements are “dicta.”  
24 When a published opinion includes a reasoned determination of an issue, it is “law of the  
25 circuit” despite the fact that it may not be logically required for the decision. *United States v.*  
*Johnson*, 256 F.3d 895, 914 (9<sup>th</sup> Cir. 2001). Because the discussion of the history and scope of  
the limitation on landlord’s claims in *In re El Toro* was germane to the ultimate decision, which  
determined that tort damages were not limited by § 502(b)(6), they are “law of the circuit,” not  
dicta.

26 <sup>5</sup> 15% of the remaining term of the lease as of the date of surrender was 12.3 months.

27 <sup>6</sup> *In re Connectix*, *supra*, 372 B.R. at 493-94.

28 <sup>7</sup> The Supreme Court recently acknowledged the legitimacy of this approach when interpreting a  
statute. *Travelers Cas. & Sur. Co. of America v. Pacific Gas & Elec. Co.*, \_\_\_ U.S. \_\_\_, 127  
S.Ct. 1199, 167 L.Ed.2d 178 (2007).

the Bankruptcy Act, a landlord's claim for rejection damages could not exceed "the rent reserved by the lease, without acceleration, for the year next succeeding the date of surrender." (Emphasis added). Absent any evidence from the plain language or legislative history of Section 502(b)(6) that Congress intended to modify how the one-year period is determined in the calculation of the rejection damage cap, this Court is inclined to accept that no such intention to change existed and that the rent reserved for one year is the year next succeeding the earlier of the petition date or date of surrender. *See Fourco Glass Co. v. Transmirra Products Corp.*, 353 U.S. 222, 227, 77 S.Ct. 787, 791, 1 L.Ed.2d 786 (1957) (stating that "no changes in law or policy are to be presumed from changes of language in the revision unless an intent to make such changes is clearly expressed"); *see also In re Woodscape Ltd. Partnership*, 134 B.R. 165 (Bankr.D.Md. 1991) (citing *Midlantic Nat'l Bank v. New Jersey Dep't of Environmental Protection*, 474 U.S. 494, 501, 106 S.Ct. 755, 759, 88 L.Ed.2d 859 (1986)).<sup>8</sup>

This analysis applies with equal force to EOP's efforts to have this Court apply the "money" model. There is nothing in the legislative history to conclude that Congress intended to abandon the time calculation when it enacted the Bankruptcy Code. Moreover, as the Bankruptcy Court observed, the statutory provision compares two time periods and is limited to a third time period. Appellees respectfully urge that the cases which adopt a "money" model were wrongly decided.<sup>9</sup>

**B. The Bankruptcy Court correctly reduced EOP's claim by the amount of the security deposit it collected**

**1. The Ninth Circuit has held that security deposits reduce landlords' claims under § 502(b)(6)**

The letter of credit security deposit that EOP held reduces the amount of its allowed claim under § 502(b)(6). EOP's contrary view of the "clear" meaning of the statute was rejected by the Ninth Circuit in 2005, when it determined that there was no distinction between cash

<sup>8</sup> *In re Usinternetworking, Inc.*, 291 B.R. 378, 381-82 (Bankr.D.Md. 2003).

<sup>9</sup> Appellant's hypothetical arguments regarding the more natural reading of the statute, the potential effects of "free rent" and the alleged discrepancy between the time and money approach deserve little comment. First, they are arguments that would apply with equal force to the "one year" calculation, which has unanimously been recognized as the next ensuing 12 month period. Second, they ignore entirely the history of the provision, which the Ninth Circuit has recognized Congress intended to carry over into the new statute. *In re El Toro Materials Co., Inc.*, *supra*.

deposits and letters of credit.<sup>10</sup> The Ninth Circuit did not limit its decision to letters of credit drawn pre-petition or post-petition, nor did it limit its decision to letters of credit that were secured or unsecured. In fact, the Ninth Circuit considered and rejected the very interpretation of the statute offered by EOP.

EOP says that “the plain language of section 502(b)(6)” provides a four step process that mandates application of its security draws to the disallowed portion of its claim rather than the allowable portion.<sup>11</sup> As explained by the Ninth Circuit, though, that analysis is incorrect:

According to AMB, the plain language of Section 502 requires a court to: (1) determine the landlord's gross damages (net of any recovery through re-letting the property); (2) subtract from those gross damages any "mitigation" from security deposits or letters of credit; (3) compare this "mitigated damages" amount to the statutory cap of one year's rent; and (4) allow a claim for the lesser of either the "mitigated damages" or one year's rent. Employing this approach, AMB's gross damages of \$5 million, minus the \$1 million Security Deposit/Letter of Credit yield "mitigated damages" of \$4 million. These "mitigated damages" exceed one year's rent of \$2 million. Accordingly, AMB argues the bankruptcy court should have allowed its entire \$2 million claim.

AMB's plain language argument is misplaced. On its face, Section 502(b)(6) makes no mention of how security deposits should be applied in the calculation of allowable claims. Thus, the statute is ambiguous as to whether such deposits should be applied to a landlord's gross damages or its capped claim. Given this ambiguity, Congress's explicit endorsement of *Oldden* [*Oldden v. Tonto Realty Co.*, 143 F.2d 916 (2d Cir. 1944)] prevents us from accepting AMB's invitation to reject the case outright.<sup>12</sup>

The Ninth Circuit went on to hold that the proceeds of the letter of credit were correctly subtracted from the landlord's allowed claim.

As the Bankruptcy Court recognized, there are only two published cases that expressly consider whether pre-petition draws on letters of credit affect “cap” calculations.<sup>13</sup> One is a

<sup>10</sup> *In re AB Liquidating Corp.*, 416 F.3d 961, 964 (9<sup>th</sup> Cir. 2005). See also *In re Mayan Networks*, 306 B.R. 295, 301 (9th Cir.BAP 2004); *In re PPI Enters., Inc.*, 228 B.R. 339, 344-45 (Bankr.D.Del. 1998) *aff'd* 324 F.3d 197 (3<sup>rd</sup> Cir. 2003).

<sup>11</sup> EOP's Opening Brief at 14.

<sup>12</sup> *In re AB Liquidating*, 416 F.3d at 964.

<sup>13</sup> *In re Connectix*, *supra*, 372 B.R. at 491. Appellant's arguments that *In re Mayan Networks*, 306 B.R. 295 (9th Cir.BAP 2004), mandates a different result are misplaced. The *Mayan* Court indicated that *PPI* would control with respect to pre-petition draws on letters of credit where the

Third Circuit case involving a landlord's claim under § 502(b)(6)<sup>14</sup> while the other is a Bankruptcy Appellate Panel case involving a terminated employee's claim as determined under § 502(b)(7).<sup>15</sup> The Bankruptcy Court here correctly agreed with the Third's Circuit's analysis. In *In re PPI Enterprises, Inc.*, the landlord had drawn on the letter of credit five years prior to the bankruptcy filing, but after the lease termination. Noting that the language of § 502(b)(6) requires the determination of the allowable claim from the earlier of the date of the bankruptcy petition or the date of lease termination, the Third Circuit affirmed the Bankruptcy Court's application of the security deposit to reduce the landlord's claim.<sup>16</sup> The Bankruptcy Court explained its reasoning in a published decision.<sup>17</sup> EOP's arguments to this Court parrot the landlord's arguments rejected by the Bankruptcy Court and the Third Circuit.

In response, Solow states that the letter of credit was not a security deposit that constituted estate property because he drew on the security deposit prior to PPI's filing, and thus it should not be applied to reduce his § 502(b)(6) claim.<sup>18</sup>

That position was soundly rejected because it ignored consistent precedent, the language of the statute, and the legislative history.

The legislative history and case law pertaining to the treatment of security deposits under § 502(b)(6) ***makes clear that any security deposit held by a landlord at the time of termination of the lease of real property will be applied in satisfaction of the claim allowed under § 502(b)(6).*** The legislative history of § 502(b)(6) states that the landlord "will not be permitted to offset his actual damages against his security deposit and then claim for the balance under [§ 502(b)(6)]. ***Rather, his security deposit will be applied in satisfaction of the claim that is allowed under***

Debtor supplied security to the issuing bank. *Id.* 306 B.R. at 311 [concurring opinion]. Thus, analysis of the issue turns on the entitlement following "faithful performance of the lease" not following default and application of the letter of credit proceeds.

<sup>14</sup> *In re PPI Enterprises, Inc.*, 324 F.3d 197 (3rd Cir. 2003). The Bankruptcy Court decision in *PPI* was cited with approval by the Ninth Circuit in *In re Sylmar*, 314 F.3d 1070, 1075 (9th Cir. 2002).

<sup>15</sup> *In re Condor Systems, Inc.*, 296 B.R. 5 (B.A.P.9<sup>th</sup> Cir. 2003), *appeal dismissed*, 125 Fed.Appx. 797 (9th Cir. 2005). At the Ninth Circuit, the appeal from the Bankruptcy Appellate Panel decision was dismissed based on a determination that the BAP decision was not a final decision. Accordingly, Appellees submit that *Condor* was of limited value as authority in the Bankruptcy Court and perhaps only represents law of the case.

<sup>16</sup> *In re PPI Enterprises, Inc., supra*, 324 F.3d at 208 n.19.

<sup>17</sup> *In re PPI Enters., Inc.*, 228 B.R. 339(Bankr.D.Del. 1998).

<sup>18</sup> *Id.* 228 B.R. at 350.

1           [§ 502(b)(6)]”H.R.Rep. No. 595, at 353-54 (1977); S.Rep. No.  
2           989, at 63-64 (1978).

3           **Moreover, cases have uniformly held that security**  
4           **deposits held by the landlord or applied by the landlord after the**  
5           **termination of the lease will be deducted from that landlord's**  
6           **§ 502(b)(6) claim. See, e.g., *In re Handy Andy Home***  
7           ***Improvement Centers, Inc.*, 222 B.R. 571, 574-75 (Bankr.N.D.Ill.**  
8           **1998); *Blatstein*, [*In re Blatstein*, 1997 WL 560119, \*16 (E.D.Pa.**  
9           **Aug. 26, 1997); 1997 WL 560119, \*16-17; *In re Atlantic***  
10           ***Container Corp.*, 133 B.R. 980, 989 (Bankr.N.D.Ill. 1991).**

11           ....However, these differences in timing are irrelevant  
12           because § 502(b)(6)'s cap on a landlord's claim takes effect at the  
13           earlier of (i) the date of filing and (ii) the date on which lessee  
14           surrenders or lessor repossesses the property. Thus, so long as the  
15           landlord applied the security deposit at a time subsequent to either  
16           (i) or (ii) above, § 502(b)(6) will require that security deposit to be  
17           subtracted from the landlord's § 502(b)(6) claim (emphasis  
18           added).<sup>19</sup>

19           Application of the security deposit to reduce the allowed § 502(b)(6) claim is appropriate where,  
20           as here, it is undisputed that EOP applied the letter of credit proceeds after the surrender and  
21           termination of the lease.

22           EOP's reliance on the Bankruptcy Appellate Panel decision in *In re Condor Systems,*  
23           *Inc.*, 296 B.R. 5 (B.A.P. 9<sup>th</sup> Cir. 2003), *appeal dismissed*, 125 Fed.Appx. 797 (9th Cir. 2005) is  
24           misplaced. That case involved a claim from a terminated employee, and therefore implicated a  
25           different subsection of § 502(b). In deciding *In re Condor Systems*, Judge Klein specifically  
26           rejected precedent involving claims from landlords, and held that the two sub-sections of  
27           § 502(b) should be construed differently:

28           Security deposits [under leases] are peculiar, term-of-art creatures  
of contract that have a rich history in the specialized field of  
landlord-tenant law that differentiates them from other lease-  
related remedies and from employment termination damages. In  
the classic model, represented by *Oldden*, 143 F.2d at 920, the  
landlord holds a refundable cash deposit representing a month or  
two of rent against the possibility of compensable damages to the  
leasehold property.

Where a letter of credit or other third-party obligation is  
intended to be a security deposit under a lease, it may be  
appropriate to analyze the situation as involving a security  
deposit. The Third Circuit, for example, recently addressed a  
letter of credit that was explicitly agreed to be a security deposit

<sup>19</sup> *Id.*

on a lease. *PPI Enter.*, 324 F.3d at 209. It does not follow, however, that every letter of credit or other third-party guarantee constitutes a security deposit. Rather, even in the landlord-tenant arena, parties must intend that it be a security deposit.

**Thus, we agree with Young and our prior panel in *Bitters* that the claims treatment of security deposits pursuant to leases of real property presents a special situation that does not readily translate to § 502(b)(7). (Emphasis added).**<sup>20</sup>

EOP also improperly cites and relies on dicta in an unpublished decision issued by Judge Montali and filed only on the Bankruptcy Court's website.<sup>21</sup> A statement on the Bankruptcy Court's website provides,

NOTICE: Publishers of court opinions should contact the judge issuing the opinion for approval prior to publishing any opinion found on this website.

EOP does not cite, and Appellees have not been able to locate, a published version of Judge Montali's memorandum decision, which suggests that he has never given permission to publish. Under the provisions of Local District Court Rule 7-14, opinions that are not designated for publication may not be cited in other cases. Nevertheless, to respond to EOP's brief, Appellees therefore explain why the Bankruptcy Court in this case was correct when it declined to adopt the same reasoning.

First, in the case before Judge Montali, the landlord and the debtor had agreed that the lease had not been surrendered prior to the bankruptcy filing, and that the pre-petition draws on the letter of credit had paid then current rent obligations under the debtor's lease.<sup>22</sup> Accordingly, as a factual matter, on the date of filing the bankruptcy petition in Judge Montali's case there was a remaining letter of credit amount, and the date for measuring the § 502(b)(6) cap was the date of filing of the petition. Judge Montali's discussion concerning a lease termination prior to the date of filing, in which he rejects *In re PPI Enterprises, Inc.* and follows *Condor*, is entirely hypothetical.

<sup>20</sup> *In re Condor Systems, Inc.*, *supra*, 296 B.R. at 18-19.

<sup>21</sup> AER, Tab 7

<sup>22</sup> AER, Tab 7, pg. 37, ln. 21-23.

Second, not only did Judge Montali discuss a hypothetical situation that was not before him, but his reliance on *Condor* is misplaced. As that decision itself states, the rules governing employee claims are different from the rules applicable to landlords. Moreover, the analysis in *Condor* is inconsistent with the Ninth Circuit's opinion in *In re AB Liquidating Corp.*, *supra*. As shown above, the Ninth Circuit never distinguished between pre-petition and post-petition draws on a letter of credit, and its decision suggests that security deposits collected after the applicable trigger date (statutorily defined as the earlier of the lease termination or the filing of the bankruptcy petition) always reduce the allowable claim. Furthermore, the Ninth Circuit expressly declined to accept the appellant's suggestion that it adopt the reasoning from *Condor*.<sup>23</sup>

Finally, Appellant's position would lead to conflicting results depending on the timing of a landlord's application of a letter of credit. Those landlords who applied their security prior to the filing of a bankruptcy court would fare significantly better than landlords who held their security on the date of filing. In the former situation, landlords would be able to recover their security and the full amount of the § 502(b)(6) claim because by the time of the filing the security would have been exhausted. The same logic would apply to cash security deposits as well as letters of credit. Quite understandably there is no case which sanctions such a result.<sup>24</sup>

<sup>23</sup> "However, despite AMB's argument, the resolution of this appeal does not require that we decide whether Judge Klein has set forth the appropriate procedure for applying letter of credit security deposits to landlords' claims." *Id.*, 416 F.3d at 965.

<sup>24</sup> Appellant's reliance on *In re Stonebridge Technologies, Inc.*, 430 F.3d 260 (5<sup>th</sup> Cir. 2005) to argue otherwise is also misplaced. In *Stonebridge* the landlord never filed a claim in the bankruptcy case. Rather, it held a letter of credit in excess of the § 502(b)(6) cap. The trustee sued to recover the amount the landlord had received in excess of the § 502(b)(6) cap. The Fifth Circuit concluded that the landlord was not limited by § 502(b)(6) because it had not filed a claim.

Thus, the damages cap of § 502(b)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter of credit unless and until the lessor makes a claim against the estate. We find, therefore, that further inquiry into the appropriate interpretation of § 502(b)(6) is unnecessary in this case because EOP did not file a claim against the estate.

*Id.* 430 F.3d at 270 (footnote omitted).

1 The Bankruptcy Court's analysis of this issue, and its decision to follow the Third  
 2 Circuit's opinion in *In re PPI Enterprises*, is correct. Nothing in the language of § 502(b)(6) or  
 3 in the legislative history indicates that the timing of the application of a security deposit makes a  
 4 difference, so long as it occurs after the termination of the lease. In this case there is no dispute  
 5 that EOP applied the proceeds of the letter of credit after the surrender of the property.

6 **2. Travelers affirms the Bankruptcy Court's analytical process, and does not**  
 7 **provide any grounds for reversal of the claim allowance in this case**

8 Appellant devotes a substantial portion of its Brief to a misguided view of the Supreme  
 9 Court's recent decision in *Travelers Cas. & Sur. Co. of America v. Pacific Gas & Elec. Co.*, ---  
 10 U.S. ----, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007).<sup>25</sup> Notwithstanding that the Supreme Court  
 11 followed precisely the same analytical process followed by the Bankruptcy Court here –  
 12 referring to pre-Code decisional authority and legislative history to provide historical context  
 13 and to shed light on the meaning of the statutory language -- EOP argues that the Bankruptcy  
 14 Court's decision is wrong because it is not based solely and exclusively on language from the  
 15 Code.

16 EOP's suggestion that *Travelers* intended to modify the long standing and well  
 17 considered jurisprudence concerning proper statutory interpretation, in favor of a "black letter"  
 18 rule requiring "textual support" in the "plain language of the code" is wrong. In *Travelers* the  
 19 Court considered the Ninth Circuit's rule that attorney's fees incurred litigating purely  
 20 bankruptcy issues could not be awarded to a prevailing party, even if a contractual or statutory  
 21 provision granted a party those rights.<sup>26</sup> As the Court explained, "[t]his case requires us to  
 22 consider whether the Bankruptcy Code disallows contract-based claims for attorney's fees based  
 23 solely on the fact that the fees at issue were incurred litigating issues of bankruptcy law. We  
 24 conclude that it does not."<sup>27</sup> The Court then examined the provisions of § 502(b) to see if there  
 25 were any provisions that would be applicable to contract based attorney fee claims.

26 <sup>25</sup> See Appellant's Opening Brief, pg. 11-13.

27 <sup>26</sup> That rule was announced in *In re Fobian*, 951 F.2d 1149 (9<sup>th</sup> Cir. 1991).

<sup>27</sup> *Travelers*, 127 S.Ct. at 1204.

But even where a party in interest objects, the court “shall allow” the claim “except to the extent that” the claim implicates any of the nine exceptions enumerated in § 502(b). *Ibid.* Those exceptions apply where the claim at issue is “unenforceable against the debtor...under any agreement or applicable law,” § 502(b)(1); “is for unmatured interest,” § 502(b)(2); “is for [property tax that] exceeds the value of the [estate’s] interest” in the property, § 502(b)(3); “is for services of an insider or attorney of the debtor” and “exceeds the reasonable value of such services,” § 502(b)(4); is for unmatured debt on certain alimony and child support obligations, § 502(b)(5); **is for certain “damages resulting from the termination” of a lease or employment contract, §§ 502(b)(6) and (7);** “results from a reduction, due to late payment, in the amount of...credit available to the debtor in connection with an employment tax on wages, salaries, or commissions earned from the debtor,” § 502(b)(8); or was brought to the court’s attention through an untimely proof of claim, § 502(b)(9).

**Travelers’ claim** for attorney’s fees **has nothing to do with** property tax, child support or alimony, services provided by an attorney of the debtor, **damages resulting from the termination of a lease** or employment contract, or the late payment of any employment tax. See §§ 502(b)(2)-(8). Nor does it appear that the proof of claim was untimely. See § 502(b)(9). Thus, Travelers’ claim must be allowed under § 502(b) unless it is unenforceable within the meaning of § 502(b)(1).<sup>28</sup>

Thus, the Supreme Court acknowledged that § 502(b)(6) is one of the express provisions of the Bankruptcy Code that provides for the disallowance of a claim as a substantive matter of federal law.

Not only did the Supreme Court look to established pre-Bankruptcy Code case authority governing claim allowance to assist its construction of the statute, it cited with approval the statutory interpretation cases which hold that the language in a new statute will not be construed to effect a change in interpretation without some express indication from Congress that it intended that result.

In light of the broad, permissive scope of § 502(b)(1), and our prior recognition that “the character of [a contractual] obligation to pay attorney’s fees presents no obstacle to enforcing it in bankruptcy,” it necessarily follows that the *Fobian* rule cannot stand. *Security Mortgage*, 278 U.S., at 154, 49 S.Ct. 84; see *Cohen v. de la Cruz*, 523 U.S. 213, 221, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998) (“We ... ‘will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure’” (quoting *Pennsylvania*

<sup>28</sup> *Id.* (Emphasis added.)

*Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 563, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990))).<sup>29</sup>

In short, the rules for construing § 502(b)(6) remain the same post-*Travelers* as they were before, and the Bankruptcy Court's decision, which was based on *In re AB Liquidating Corp.*, *supra* (interpreting the language based on *Oldden v. Tonto Realty Co.*, 143 F.2d 916 (2d Cir. 1944) and *PPI Enterprises, supra* is correct and should be affirmed.

### 3. The Bankruptcy Court's Decision Was Properly Supported

The Bankruptcy Court correctly found, based on the terms of the lease which was properly in the record before it, that the security deposit/letter of credit was property of the debtor. The Bankruptcy Court's factual findings need not be based solely on "evidence" presented at the hearing. The applicable Ninth Circuit authority expressly permits Bankruptcy Judges to consider all of the evidence previously presented in connection with other matters in making factual determinations.<sup>30</sup> Here, the lease was in the record as EOP had submitted it in conjunction with its claim.<sup>31</sup> The Bankruptcy Court summarized the relevant provision of the lease:

Under section 4 of the lease, which is entitled "Security Deposit," Connectix had to provide EOP with a \$50,000 security deposit in the form of cash or a letter of credit. Section 4 also required Connectix to deliver an additional "Letter of Credit, pursuant to the provisions contained in Section 36." Section 36, in turn, provided that the requisite letter of credit would, initially, be in the amount of \$2,111,205, subject to the specified reductions beginning in year five. EOP was entitled to draw the entire amount of the additional letter of credit upon any event of default, but any amount drawn was to be held "as a security deposit, subject to the terms of Section 4." **Any unused security deposit was to be returned to Connectix at the expiration or termination of the lease.**<sup>32</sup>

<sup>29</sup> *Id.* 127 S.Ct. at 1206-07.

<sup>30</sup> *In re Acequia*, 787 F.2d 1352 (9<sup>th</sup> Cir. 1986); *Jonas v. U.S. Small Bus. Admin. (In re Southland Supply, Inc.)*, 657 F.2d 1076, (9<sup>th</sup> Cir. 1944).

<sup>31</sup> AER, Tab 18. See, particularly, pp. 169 and 226-227.

<sup>32</sup> *In re Connectix, supra*, 372 B.R. at 489.

1 EOP has not disputed that the lease was properly in evidence. Because that document  
2 alone is sufficient to sustain the Bankruptcy Court's conclusion, EOP's challenge to the decision  
3 fails.

4 **4. EOP's Newly Raised Evidentiary Claim Has Been Waived**

5 In the Northern District of California, the claim objection process in Bankruptcy Court is  
6 governed by Local Rule 3017-1. That rule provides that if any party asserts that a factual  
7 dispute exists, the initial hearing will be a status conference and the Court will not receive any  
8 evidence:

9 Where a factual dispute is involved, the initial hearing on an  
10 objection shall be deemed a status conference at which the Court  
11 will not receive evidence. Where the objection involves only a  
12 matter of law, the matter may be argued at the initial hearing.  
13 Any notice of hearing on the claim objection shall so state.<sup>33</sup>

14 At the hearing, and consistent with the Local Rule, the Court inquired as to whether there were  
15 any factual disputes. Despite two specific questions from the Court, EOP never stated that an  
16 evidentiary hearing was required.<sup>34</sup> In fact, its counsel implied just the opposite, twice advising  
17 the Court that EOP had no basis to dispute the only potentially disputed "fact," namely whether  
18 the letter of credit was secured by property of the debtor:

19 THE COURT: So, you don't think there – you really don't think  
20 there are any factual issues there.

21 MS. SORENSEN [counsel to the Trustee]: No.

22 THE COURT: Okay. I'm going to accept that. Nobody else  
23 thinks there's any factual issues here; do they?

24 MR. GREGER [EOP's counsel]: Your Honor, we simply don't  
25 know whether or not it's secured or was secured or not secured by  
26 assets of the debtor.<sup>35</sup>

27 Later in the hearing, the following occurred:

28 MR. GREGER: It did, Your Honor. I just wanted the record to  
be clear that from the landlord's perspective, we don't know

<sup>33</sup> The Trustee's hearing notice did expressly include the required information. AER Tab 6, pg. 25.

<sup>34</sup> Although EOP's Opening Brief asserts that it "raised the Trustee's lack of evidence at the hearing on the objection." EOP fails to cite a reference to the transcript where that occurs and an examination of the transcript shows just the opposite, it never occurred.

<sup>35</sup> AER, Tab 17, pg. 115, ln. 19-25, pg 116, ln. 1-2.

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Memorandum,<sup>41</sup> it did not argue the issue at the hearing, nor did it request a ruling on the issue from the Bankruptcy Court. During that hearing, the Bankruptcy Judge twice inquired whether there was any disputed fact. Both times, EOP's counsel declined her implicit invitation to convert the hearing into a status conference and schedule an evidentiary hearing. Under any reasonable interpretation of the Local Rules and the representations of EOP's counsel, Judge Morgan was justified in concluding that the facts were undisputed and that the issue should be decided as a matter of law.<sup>42</sup>

This Court should emphatically reject EOP's efforts to sandbag the Bankruptcy court, the Trustee, and the other interested parties. A party cannot obtain review of an issue that it failed to properly raise below. The general rule in the Ninth Circuit is that "[a]n appellate court will not review an issue not raised or objected to below unless necessary to prevent manifest injustice." *Jonas v. U.S. Small Bus. Admin. (In re Southland Supply, Inc.)*, 657 F.2d 1076, (9th Cir. 1981). *See also In re Hongisto*, 293 B.R. 45 (D.C.N.D.Cal. 2003).

#### IV. CONCLUSION

For the foregoing reasons, Appellees respectfully urge the Court to affirm the Bankruptcy Court's thoughtful, well reasoned, and correct analysis of the issues surrounding the allowance of EOP's claim as a matter of federal law.

Respectfully submitted,

DATED: November 19, 2007.

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By 

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DATED: November 19, 2007.

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<sup>41</sup> AER, Tab. 7.

<sup>42</sup> *See also Pope v. Savings Bank of Puget Sound*, 850 F.2d 1345 (9<sup>th</sup> Cir. 1988) (finding that counsel waived right to jury trial by failing to object to Judge's announced intention).

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